Equity Redemption

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Equity Redemption

Equity redemption is the process of returning equity in cast to member-patrons who have previously invested. Simply put, equity redemption is paying members, in the form of cash or other property, previously issued equities. The Board of Directors of the cooperative makes the decision to redeem equities after determining if the cooperative's financial position allows them to do so. The over-invested or inactive members should not be responsible for financing a cooperative they do not use. Failure to redeem equity reduces member realized return on equity (ROE).

The Equity Redemption Budget

The equity redemption process should be based on an equity redemption budget. Developing a redemption budget ensures that the board is managing the cooperative's financial structure. In the absence of a redemption budget, the firm's financial structure becomes the residual outcome of the redemption decisions. The budgeting process ensures that the "tail doesn't wag the dog." The process of developing a budget is as follows:

Redemption Budget Calculations

Beginning equity	$1,000,000
+ Additional Investment from stock patronage refunds or additions to unallocated equity	$200,000
= Maximum equity	$1,200,000
– Ending equity (target)	$1,100,000
= Redemption budget	$100,000

Equity Redemption Programs

As equity is accumulated in the cooperative, an equity redemption program is used to uphold and control the level of equity in the system. An equity redemption program defines the way that one or more classes of equity are treated for redemption. The redemption policy is used of everyone in a particular equity class. The overall program should be consistent with the cooperatives equity management objectives. There are several methods of managing this equity, including special programs, which triggers redemption by the occurrence of a certain event, and systematic programs such as age of patron or revolving funds methods. Following are some frequently used programs, which can be used individually or in combination.

Common Redemption Methods

- Special Programs (uses trigger event)
- Age of Patron (oldest first)
- Age of Patron (pro-rated)
- Age of Stock
- Base Capital plan
- Percentages of all Equities plan

Special Programs

Under a special redemption program the member's entire equity is due at one time. An event must trigger the redemption such as:

- Member death
- Age of Patron
- Retirement from farming
- Moved out of trade area
- Hardship
- Estates

Special equity redemption programs are typically the default programs used by cooperatives that have generated sufficient cash flows to fund a systemic program. Special programs are usually used in combination with a systematic method. In fact, most systematic programs have supplemental special programs. This is because many members continue to do business and receive equity after a systematic program redeems their equity. These equities may be redeemed through a special program that takes over after systematic redemption has already taken place.

Advantages

Special Programs are used to reduce the financial burden on the cooperative. Therefore, special programs are often used by cooperative that do not have the financial strength to carry out a systematic program. In this program high priority cases get attention when other plans are not working. A special program may be acceptable if the cooperative is offering favorable prices. By adding some aspects of a special program to another systematic program, it allows cooperatives more flexibility in their equity management system.

Disadvantages

A special redemption program makes financial planning difficult because the cooperative cannot anticipate the events that will trigger redemption. Because a special program generally results in a very long redemption period, is does tie equity base with current patronage. The lengthy revolving period also results in members getting a poor realized return on their equity redemption.

Age of Patron (oldest first)

The patronage redeems when the patron reaches a specific age. This system assumes that the member is a natural person and not a limited liability company, corporation, or trust. Cooperatives using the age of patron system with members who are not natural persons must use a "look-through" procedure to use the age of the underlying member. The age of patron system also requires the cooperative to obtain and maintain patron birth date information.

Advantages

The Age of Patron is simple and easy to understand. This method also works well for cooperatives with favorable price.

Disadvantages

Young farmers have little incentive to participate. The age of patron method does a fairly poor job of keeping equity investment proportional to patronage. Members also tend to expect redemption regardless of the financial condition. Varying the trigger age to control the redemption amount can be controversial. This makes it difficult for the board to vary redemption in accordance to a redemption budget.

Age of Patron (pro-rated)

Redeems a portion of each patron accounts for patrons past a set age, and the cooperative establishes a redemption budget. For example, a pro-rated system might redeem a percentage of equity for all members more than 65 years old. Some cooperatives vary the yearly redemption percentage in accordance with the redemption budget while others use a fixed percentage.

Advantage

The pro-rated method is easier to integrate with the redemption budget. More members receive redemptions and it is popular with members who are eligible for AOP (Age of Patron).

Disadvantage

The age of patron pro-rated system is generally superior to an age of patron system in keeping equity proportional with cooperative use. However, it is not as proportional as the age of stock or base capital system. The pro-rated system also redeems equity at a decreasing rate. In theory, a member's equity would never be redeemed, as they would receive a percentage of their balance each year. In practice, most cooperatives distribute the remaining equity in a lump sum at a predetermined time period or equity balance. Cooperatives using a fixed redemption percentage do not have flexibility in determining the amount of redemption, making it difficult to adhere to a redemption budget.

Age of Stock

Under the age of stock plan, also called a revolving fund plan, redemptions are based on the age of the stock, using a FIFO, "first in-first out" system. The oldest year of equity is repaid before equities of later years are redeemed. The board may adopt a policy that sets a target revolving fund period. Age of stock plans are operated with revolving periods anywhere from 18 months to 30 years. Some cooperatives, particularly those that have undergone mergers, have multiple revolving funds.

Advantages

The age of stock plan is easy to understand and administer. Equity redemption is somewhat proportional to use, provided the revolving period is kept relatively short. The cooperative can control redemptions and adhere to a redemption budget by adjusting the length of the revolving period. Varying an age of stock revolving period is generally less controversial than varying an age of member redemption trigger age.

Disadvantages

With the revolving fund plan there will be good year problems and bad year problems. Disparities can occur between equity and use. Members may also expect fixed revolving regardless of financial conditions.

Base Capital Plan

With this plan, a base equity is established where under-invested members continue to increase investments, while over-invested members get partial or total redemption. This plan can also be combined with a variable cash patronage refund plan, and over-invested members receive large cash refunds.

The base capital plan keeps member investment proportional to cooperative use. It involves periodic adjustments to a member's required investment to keep it aligned with the proportional use of the cooperative. By calculating each member's patronage on average over a base period, proportional use is determined. The base period may range from one to 10 years; the length of the base period is different depending on the type of cooperative. At least once per year, equity capital requirements are estimated. Each member's proportional share must also be determined. After the results of the calculations are analyzed, each member will be determined to be under-invested, over-invested, or at the required level of investment. Under-invested members will need to invest additional funds, and over-invested members will have a redeemable equity.

The base capital plan is very effective and often used by regional cooperatives, such as CoBank. For example, CoBank may ask for additional investment from under-invested patrons before offering a loan amount. This plan is used infrequently by local cooperatives because additional investment is not as easily obtained.

Advantages

This method keeps member investment directly proportional to use. The current users maintain ownership and control. Capital requirements also may be systematically adjusted, allowing for flexibility in equity management.

Disadvantages

It is relatively difficult to understand and management is complex. The system becomes ineffective if there is a constant and heavy member turnover. New members may be discouraged due to a possible large initial investment.

Percentage of All Equities

(After trigger age: after 65)

This method reduces member equity by percentages and retiring a percent of outstanding equity, regardless of issuance. It is used by a limited number of cooperatives.

Advantages

Rewards new patrons and works well for cooperatives with a stable membership and patronage. The program is easy to understand and administer.

Disadvantages

With the percentages of all equities, there can be a poor transfer of ownership. Transfer of ownership cannot be completed with out additional provisions from the cooperatives.

Alternatives to Redemption

Although not practical for many cooperatives, there are alternatives to traditional redemption methods. These include:

- Partial Redemption or Discounting
- Conversion to Debt or Preferred Stock
- Exchange of Equity Between Members

Partial Redemption or Discounting

With such a program, members get paid a discounted value of future equity redemption. This system could obviously not be applied to every member, as it would eliminate the cooperative's equity. It can be an effective system for a cooperative to manage the equity of inactive members. The inactive member receives some immediate funds for their equity, and the cooperative is freed of future redemption obligations. One difficulty in developing a partial redemption system is the selection of the discount rate. The income tax consequences are not well established.

Conversion to Preferred Stock

Another innovative equity management strategy is to allow members to convert common equity into preferred stock. The preferred stock would generally pay dividends at the 8 percent allowable rate. The preferred stock would generally not be redeemed, but could be exchanged among members. Converting common equity to preferred stock eliminates the future commitment of redemption at the cost of annual dividend payments. Unlike debt, the preferred dividends payments can be suspended in times of financial strain.

This strategy improves the cooperative's cash flow, but it changes their balance sheet, which gives members more return. This also allows exchange of equity between members even though the markets of members are limited. Purchase price may not be realized as a value, and member income tax issues are unclear.

Exchange of Equity between Members

Many closed cooperatives involved in value-added operations (often called new generation cooperatives) allow members to buy and sell equity. The board of directors must generally approve the transaction. The price is privately negotiated. The delivery rights associated with new generation cooperative stock provide the incentive for stock ownership. An exchange system would be unlikely to be used in a traditional cooperative since there is no incentive for additional stock ownership.

Advantage

The exchange reflects true market value. It allows members to receive immediate value for their cooperative equity without reducing the cooperative's cash flow. The market value also provides managers with feedback as to the market perception of future cooperative performance, having immediate cash for equity sold.

Disadvantage

Limited markets among qualified members and the purchasers face risk of depreciation of stock.

Conclusion

Equity Programs should raise adequate equity and minimize redemption burden. It should also assure fair treatment and generate adequate returns over time. Finally, a cooperative should choose an equity redemption plan that meets their specific circumstances. The age of patron method is the least desirable because it is the least proportional. The best plan for most cooperatives is age of stock combined with specialized estates redemption method. No simple strategy is best for everyone. Cooperatives must make the decision of which equity redemption strategy they will use, based on the nature of their business.

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Extension carries out programs in the broad categories of agriculture, natural resources and environment; family and consumer sciences; 4-H and other youth; and community resource development. Extension staff members live and work among the people they serve to help stimulate and educate Americans to plan ahead and cope with their problems.

Some characteristics of the Cooperative Extension system are:

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- It is administered by the land-grant university as designated by the state legislature through an Extension director.
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- It provides practical, problem-oriented education for people of all ages. It is designated to take the knowledge of the university to those persons who do not or cannot participate in the formal classroom instruction of the university.
- It utilizes research from university, government, and other sources to help people make their own decisions.
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